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SOME LIMITATIONS OF THE TRUST-FUND DOCTRINE.

The booms have brought home to some of us the question of a stockholders's liability on "bonus" or "watered" stock. Those lawyers who are not themselves prosecuted thereon are largely engaged in prosecuting or defending others, and, it is hoped, are ready to read anything bearing on the subject.

In England the issue of such stock is largely regulated by statute. Judge Story first enunciated what is now, in the absence of statute, the familiar "American doctrine" on the subject, viz: that the unpaid capital stock of an insolvent corporation is a *trust fund* for the benefit of corporate creditors. The public are justified in believing that a company, which is represented as capitalized at a certain amount, has the par value of such stock in money or its equivalent, and, to the extent that this is not true, it is a deception and fraud upon the public. For this reason a corporation cannot give away its stock, sell it below par, or release a subscriber from the payment of his subscription to the detriment of creditors. Such an arrangement may be good against the corporation, but is void as to those creditors who relied upon the proceeds of such stock as a corporate asset for the payment of their claims. If the corporation is insolvent, a court of equity will *imply* a promise by the holder to pay par value for his stock.

Stockholders, however, are not considered to have given their promissory notes for the unpaid balance on their stock; the "trust-fund" doctrine is a creation of equity, invoked to do justice or to prevent fraud; and there are creditors for whom, and stockholders against whom, it will not be invoked.

Creditors can realize upon unpaid stock because they had a right to rely upon it as an asset when they extended credit to the company, and either did in fact rely upon it or extended credit to the company under such circumstances that the court will presume they relied upon

it. When this reason for the rule does not exist, the doctrine will not be invoked—there is nothing sacred about it. To illustrate:

(1). Should the creditor know at the time he extends credit to the company, that its stock, though issued as full paid and non-assessable, has been in fact issued gratuitously, or at less than par, then he cannot collect the unpaid balance from stockholders. He stands in the shoes of the corporation and has no greater rights than the corporation would have. He dealt with his eyes open and cannot complain. Knowing the facts, he had no right to rely upon such stock as an asset for payment of his claim, and is not presumed to have done so. There is no reason why a court of equity should invoke the doctrine in his favor.[1]

(2). A *bona fide* purchaser of "watered stock" may rely upon a statement on the face of the certificate that the stock represented by it is full paid, although th fact be otherwise. It would be unjust to make such holder bear the burden of a wrong committed by the company or its agents. The court will consider the equity of such a holder as offsetting that of a creditor. The convenience of trade is in this case another argument against applying the doctrine.[2]

(3). A company may relieve itself from embarrassment by paying a debt in stock at its real value, without subjecting the creditor surrendering his debt to the liability attaching to corporate stockholders who have agreed expressly or impliedly to pay the face value of stock subscribed by them. Such a transaction benefits other creditors, diminishing the number who would be entitled to share in the assets of the company, and benefits other stockholders for the same reason.[3]

(4). If an active corporation finds it necessary to increase its capital stock in order to pay debts, and raise money to prosecute its business, it may issue new shares of stock and put them upon the market for the best price obtainable, and if the transaction be *bona fide*, and the consideration obtained represents the actual value of such stock, the purchaser cannot be called upon to respond for its par value.[4] The original stock having fallen below par, a corporation could never increase its capital by sale of shares if the rule were otherwise. All purchasers would buy stock at its market value from some original holder. A creditor who relied upon such stock might feel

[1] See Cook on Stock & Stockholders, sec. 46; 2 Morawetz, Priv. Corp. (1st ed.), sec. 597; 1 Beach Priv. Corp., sec. 119; *Martin* v. *So. Salem Land Co.*, 94 Va. 28.

[2] 2 Thompson Corp., secs. 1583, 1680 *et seq.*; 2 Morawetz, Priv. Corp., sec. 591.

[3] *Clark* v. *Bever*, 139 U. S. 96.

[4] *Handley* v. *Stutz*, 139 U. S. 417.

aggrieved, but equity refuses to invoke the "trust-fund doctrine" to help him.

It was a frequent practice during recent "boom times" for an active corporation to declare a new issue of stock, certify it as full paid and non-assessable, and then distribute it gratuitously to officers and promoters, or sell it for less than par, or in exchange for property at an overvaluation. Sometimes one company of limited and full paid capital was organized, property bought and debts contracted, and then assets and liabilities transferred to a new company in exchange for a large block of its full paid stock, and the stock thus acquired distributed to members of the old company. Creditors always pursue such stockholders, relying upon the trust-fund doctrine; but another limitation of that doctrine here comes into play, which it is the purpose of this article to state, and to examine in light of the authorities, viz:

(5). Creditors of a corporation cannot complain if stock is issued gratuitously or at less than par, if the issue were subsequent to the creation of their claims against the company. A creditor is undoubtedly entitled to claim that every share of the capital upon the security of which he gave the company credit, shall be paid in money or money's worth, but here his rights cease, and he cannot collect on stock upon which he did not rely as a security for his debt.

"Where the capital stock of the corporation is increased, the increase is not a trust fund for the benefit of corporate creditors who were such before the increase was made."[1]

"With the increasing tendency of judges to subordinate the rights of creditors to those of the members of corporations, those creditors who became such *prior* to the issuing of the shares held by the shareholder sought to be charged, and who have not dealt with the company on the faith of any capital represented by such shares, cannot insist on the contribution by the holders of a greater amount of the capital than the corporation itself could claim from them as a part of the assets."[2]

"The creditors of a corporation must be held to have given credit upon the security of the capital stock required by the charter of the company to be subscribed at its formation. And if this amount has been subsequently increased by amendment of the company's charter, the same principle is obviously applicable with respect to the increased capital, in favor of those creditors who contracted with the company after the increase was made.

"On the other hand, if the nominal capital of a corporation is reduced under authority conferred by law, persons who have given credit to the company with notice of such reduction cannot call upon the shareholders to contribute more than the diminished amount of capital, for they have given credit to the company upon the security of that amount alone.

[1] 1 Cook, Stock & Stockholders, sec. 46.

[2] 3 Thompson, Corp., sec. 3680.

"And so where a corporation has issued new shares after a creditor has made his contract, or where shares have been issued of which the creditor had no notice, either actual or constructive, it is clear that he cannot have trusted the company upon the security of the capital represented by those shares. And there seems to be no reason for holding that the creditor would have any better rights in equity against the holders of such new shares than belonged to the company itself." [1]

"A corporate creditor cannot object to an issue below par of new capital stock, the increase having been made after he had extended credit to the company; for in such a case he cannot be presumed to have acted upon the faith of the increased capital stock being issued for its full face value." [2]

In *Coit* v. *Gold Amalgamating Co.*[3] there was a new issue of stock, the holders of old stock returning it, and for each share returned receiving four shares of the new stock (itself afterwards cancelled) without furnishing further consideration. The claim in question originated at the time and as part of this transaction. Justice Field, delivering the opinion of the court, said:

"Nothing was done after the increase to enlarge the liabilities of the company. The plaintiff had placed no reliance upon the supposed paid-up capital of the company on the increased shares, and, therefore, has no cause of complaint by reason of their subsequent recall. Had a new indebtedness been created by the company, after the stock and before its recall, a different question would have arisen. The creditor in that case, relying on the faith of the stock being fully paid, might have insisted upon its full payment. But no such indebtedness was created, and we think, therefore, that the stockholders cannot be called upon, at the suit of the plaintiff, to pay in the amount of the stock, which, though issued, was soon afterwards recalled and cancelled."

The court, in *First National Bank of Deadwood* v. *Gustin M. C. M. Co.*,[4] in its opinion, says:

"While the courts have not always had occasion to state the limitations upon the doctrine that 'the capital is a trust fund for the benefit of creditors,' yet we think that it will be found that in every case where they have impressed a trust upon the subscription of the shareholders, it has been in favor of creditors becoming such afterwards, and hence fairly to be presumed as relying upon the amount of capital which the company was represented as having. . . . . If a corporation issue new shares after the claim of a creditor arose, it is clear that the latter could not have dealt with the company on the faith of any capital represented by them. Whatever was contributed as capital in respect to the new shares was a clear gain to the creditor's security."

In *Handley* v. *Stutz*[5] the lower court held that original subscribers,

[1] 2 Morawetz, Priv. Corp. (1st ed.), sec. 597.
[2] 1 Beach, Priv. Corp., sec. 119.
[3] 119 U. S. 343 (1886).
[4] 18 Am. St. Rep. 510 (Minn. 1890).
[5] 139 U. S. 417 (1891).

to whom part of a new issue of stock was distributed gratuitously, were free from liability for debts contracted prior to the new issue, because, as between the company and the stockholders, the latter held such stock properly, and without liability to the company, and all creditors who dealt with the company *prior* to such increase, and not upon the faith of such stock, had no equity to demand more than the company itself could; but that such subscriptions did constitute a trust fund for the benefit of creditors whose claims accrued *after* the increase was voted. On this point the decision was approved by the Supreme Court.

In *Hospes, &c.* v. *Northwestern, etc. Car Co.*,[1] in which the plaintiffs had bought up claims against the company, the court cites cases in which the equity was held not to arise in favor of certain creditors, and reduces the whole doctrine to a question of *fraud on creditors*, saying in part:

> "The capital of a corporation is the basis of its credit. It is a substitute for the individual liability of those who own its stock. People deal with it and give it credit on the faith of it. They have a right to assume that it has paid in capital to the amount which it represents itself as having; and if they give it credit on the faith of that representation, and if the representation is false, it is a fraud upon them; and in case the corporation becomes insolvent, the law upon the plainest principles of common justice, says to the delinquent stockholder: 'Make that representation good by paying for your stock.' It certainly cannot require the invention of any new doctrine in order to enforce so familiar a rule of equity. It is the misrepresentation of fact in stating the amount of capital to be greater than it really is that is the true basis of the liability of the stockholder in such cases; and it follows that it is only those creditors who have relied, or who can fairly be presumed to have relied, upon the professed amount of capital, in whose favor the law will recognize and enforce an equity against the holders of 'bonus' stock. This furnishes a rational and uniform rule, to which familiar principles are easily applied, and which frees the subject from many of the difficulties and apparent inconsitencies into which the 'trust-fund' doctrine has involved it; and we think that, even when the trust-fund doctrine has been invoked, the decision in almost every well-considered case is readily referable to such a rule."

See also *Buehler* v. *McCormick*[2] and *Shields* v. *Clifton Hill Land Co.*[3]

In the case last mentioned, the court recognizes this limitation as part of the "American common law" on the subject, inapplicable to that case only by reason of a special statute of Tennessee making *all* unpaid stock a fund for the payment of *all* debts. This case gives

[1] 15 L. R. A. 470 (Minn. 1892).
[2] 48 N. E. 285 (Ohio, 1897).
[3] 26 L. R. A. 509 (Tenn. 1894).

arguments on both sides of the question. Counsel contended against the limitation, saying that the reason of the doctrine is that an unpaid subscription to stock is capital of the corporation, liable in the last resort to the payment of all just debts; that there is no difference in this respect between the liability of corporations and of natuaal persons; that inasmuch as in case of credit extended to a natural person, the creditor has a right to look, not only to the property he then has, but also to all that he may thereafter acquire, the corporate creditor should have the same right; and that all property of natural or artificial persons, whenever and however acquired, unless expressly exempted by law, is liable for all valid debts of the one or the other, whenever created.

The court admitted these to be forcible views, but refers to the principle as firmly established.

If, then, the trust-fund doctrine rests upon the actual or presumed reliance by the creditor at the time his debt was created, upon the then existing capital stock of the corporation for payment, it could not be invoked against stockholders of a new company which has assumed the debts of an old in favor of creditors of the old company. Capital subscribed to the old company is a fund pledged for payment of its debts, but if the creditors in question did not trust the new company upon the faith of its stock, they cannot complain of the manner in which it is paid; though it be issued gratuitously, no asset is lost to which they looked for payment of their claims when created.

There are comparatively few reported cases in which the attempt has been made to limit the trust-fund doctrine to the capital stock of a corporation existing at the time a debt is created, but we find no case where the principle is repudiated. As the courts have applied it, the limitation seems to be based upon sound principles. It is not claimed to be an absolute rule, freeing each stockholder from liability for all debts contracted prior to his subscription—it applies to a *new issue* of stock, not to the sale of each *separate share* under that issue. When a new issue of stock is ordered, this is a fact to which publicity would naturally be given, and while only creditors subsequent to the increase are presumed to have relied upon it, yet such creditors could not be expected to know when and by whom such stock would be taken, and when shares are taken they become available to all creditors becoming such after the increase.[1] And so when the amount of capital stock is definitely fixed in the charter, creditors are presumed to have con-

[1] See *Handley* v. *Stutz* (*supra*).

tracted with reference to the charter capitalization, not to the amount actually subscribed for at the time of their contract.[1] In other words, no court would attempt to gauge the liability of each stockholder separately by the exact time when he took his stock, with reference to the dates when the several claims of creditors accrued; even the flexibility of a court of equity would not admit of this. With this reasonable qualification, the rule of non-liability of stockholders for antecedent debts of the corporation may be considered established as part of the trust-fund doctrine.

J. BALDWIN RANSON.

Staunton, Va.

WHAT IS ORDINARY CARE IN THE USE OF HIGH EXPLOSIVES?

(*Bertha Zinc Co.* v. *Martin*, 93 Va. 791.)

The principle of law announced by the Court of Appeals in response to the above question is of more than local interest. Let us note the facts as they appeared in the case.

Samuel Martin was an employee of the Bertha Zinc Company, engaged in the mining of zinc ores. The workmen were engaged on the morning of the accident in what is termed surface mining, carried on by digging a cut into the hill and blasting down blocks of ore and earth from the head of the cut. For the purpose of this blasting, dynamite was used. The morning of the accident was a cold, crisp morning in November, and it became necessary for the workmen to leave their work occasionally and go to a fire, which had been built against an old stump in the open for the purpose, to warm themselves. At the time Martin went to the fire to warm he had just finished drilling a hole in the bank for the purpose of putting in a charge of dynamite. Carico, another workman, was engaged at this time in thawing out sticks of dynamite by this open fire to prepare them for use in blasting, having some of the sticks standing with one end resting on the ground near the fire and holding one stick in his hands before the fire. While so engaged, and while Martin was standing by the fire, the explosion occurred, just how, the parties were unable to say. Carico had both his hands torn off, and was otherwise injured; Martin re-

[1] 2 Morawetz, Priv. Corp., secs. 781, 823.